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DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA-SETH SEARLS
COMMERCE FOR 4430/GOLIKE
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR FINEMAN
DEPARTMENT PASS EXIM BANK

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TAGS: EFIN EINV ECON PGOV ID
SUBJECT: INDONESIA'S ECONOMY ONE YEAR AFTER THE FUEL PRICE
HIKES

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¶1. (SBU) Summary. Indonesia successfully restored macroeconomic stability in the first half of 2006 after the August 2005 rupiah "mini-crisis" and the fuel price hikes and interest rate increases that followed. After the Government of Indonesia (GOI) hiked fuel prices by an average of 126% in October 2005, high inflation resulted. Bank Indonesia (BI) raised interest rates by a total of 425 basis points in response, curbing inflation expectations and sharply limiting the hoarding of consumer goods. One year after the implementation of the fuel price hikes, the economy is on target to recover in the second half of 2006 and the near-term downside risks to economic growth and stability are limited. Delays in enacting labor, tax and investment reforms, however, may negatively impact the macroeconomic environment in the longer run. End Summary.

Economic Conditions Stabilize After the Mini-Crisis
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¶2. (U) The GOI introduced two important policy measures to address a bout of macroeconomic instability in the third quarter of 2005. Most prominent was the 126% average hike in fuel prices on October 1, 2005, reducing increasingly costly government subsidies in an environment of rising global oil prices. This policy, which amounted to a transfer from consumers to the GOI of an estimated 3-4% of gross domestic product (GDP) ($7.5-10 billion), put Indonesia's fiscal spending on a sustainable path. In addition to the fuel subsidy reduction, BI raised its benchmark interest rate from 8.5% in August 2005 to 12.75% in December 2005 in an effort to curb the depreciation of the rupiah. These policies were largely successful in restoring macroeconomic stability in Indonesia (Ref A).

¶3. (U) After the two policies took hold, the rupiah appreciated steadily in response to tighter monetary policy and more prudent fiscal policy. The Indonesian currency firmed from over 10,000 Rp/USD in September to less than 9,000 Rp/USD by May 2006, and has remained in the 8,800/USD - 9,300/USD range since. Higher interest rates also increased the interest rate differential between Indonesia and the rest of the world, particularly the United States,

encouraging renewed interest among portfolio investors in Indonesia's capital markets. According to BI, net portfolio investment liabilities jumped to $3.5 billion and $4.1 billion in the fourth quarter (Q4) of 2005 and first quarter (Q1) of 2006, respectively. Increased portfolio flows in turn contributed to a significant improvement in Indonesia's foreign exchange reserves, which moved from $30 million in September 2005 to over $44 million by May 2006. The increase in reserves allowed Indonesia to repay its entire $6.94 billion debt to the International Monetary Fund in separate tranches in June and October 2006, well in advance of scheduled repayment. In February 2006, Standard and Poor's changed the outlook for Indonesia's sovereign rating from stable to positive.

## Impact on Consumer Demand Slows Growth

¶4. (U) The fuel price hikes and interest rate increases stabilized the economy, but also led to slower growth in late 2005 and early 2006. Overall GDP growth slowed to less than 5% year-on-year (YoY) during the last quarter of 2005 and the first quarter of 2006, but remained roughly at or above GDP growth rates recorded during the 2000-2004 period. Further, GDP growth increased during the second quarter of 2006 to 5.2% (YoY). Nevertheless, growth rates remain well below the Government's 6.6 average annual growth target for 2005-09.

¶5. (U) The sharp reduction in fuel subsidies in October 2005 introduced a significant price shock to the domestic economy across a wide range of products. Headline inflation jumped from 9.1% in September 2005 to 17.9% in October 2005.



Fortunately, there was no hoarding of consumer goods. As illustrated in Table 1, real growth in household consumption, which accounts for almost 60% of gross domestic product (GDP), slowed in response to the price increases, dropping from 4.2% YoY in Q4 of 2005 to 3.2% YoY in the Q1 of 2006. The decline in household spending growth continued in the second quarter of 2006, increasing by only 3% YoY.

Table 1: Real GDP Growth, 2005-2006, Year-on-Year

| | 2005 Q3 | 2005 Q4 | 2006 Q1 | 2006 Q2 |
|---|---|---|---|---|
| Household Consumption | 4.4 | 4.2 | 3.2 | 3.0 |
| Government Consumption | 14.7 | 30.0 | 14.2 | 31.6 |
| Fixed Capital Formation | 9.4 | 1.8 | 2.9 | -1.0 |
| Exports of Goods and Services | 4.8 | 7.4 | 10.8 | 11.3 |
| Imports of Goods and Services | 10.6 | 3.7 | 5.0 | 8.3 |
| GDP | 5.6 | 4.9 | 4.6 | 5.2 |

Source: Central Bureau of Statistics

¶6. (U) In addition to slowing household demand, the fuel price hikes coupled with delays in implementing investment climate reforms weakened already soft investment growth in Indonesia. Fixed capital investment grew at an anemic 1.8% YoY in Q4 of 2005, and increased only slightly to 2.9% YoY in Q1 of 2006, before contracting 1.0% YoY in Q2. More positively, fiscal stimulus and gains from trade prevented a more significant slowdown in GDP growth. Strong growth in government spending linked to compensation programs for the fuel price hikes supported overall GDP expansion in the fourth quarter of 2005. However, growth in government

spending weakened in 2006 as bureaucratic inefficiencies reemerged and local governments failed to spend funds. Nonetheless, the government was able to significantly increase spending in the second quarter of 2006. As shown in table 1, growth in government spending slowed to 14.2% YoY in the first quarter of 2006, before rebounding in the second quarter to 31.6% YoY.

¶7. (U) Indonesia's exports of goods and services grew robustly in the first half of 2006. The strong growth was centered on non-oil exports and supported by robust global demand and an increase in global prices for Indonesia commodities, such as rubber, palm oil, coal, and cooper. This improvement coupled with a slowdown in import growth resulted in a strong trade surplus. Import growth slowed in response to weaker domestic demand. Import growth fell to 5% YoY and 8.3% YoY, respectively, in the first and second quarters of 2006, with a slowdown in oil imports responsible for most of the decline. Growth of consumer goods imports remained strong, growing almost 17% YoY over the January to May 2006 period, but growth in imports of intermediate goods dropped 5.2% YoY during the same period, signaling a slowdown in manufacturing.

Signs of Increased Growth in Second Half of 2006
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¶8. (U) In May 2006, BI began lowering interest rates in response to lower inflation expectations and an improved balance of payments position. Headline CPI inflation slowed to 14.55% YoY in September, down from 14.9% YoY and 15.15% YoY in the two previous months. The YoY inflation rate will decline significantly in October with the elimination of the base effect from the fuel subsidy reduction. The IMF estimates that the full year 2006 headline inflation rate will be roughly 7%, in line with Indonesia's historical



performance. The recent fall in world oil prices is having some impact on the inflation rate, as the GOI reduces non-subsidized domestic oil prices in the line with global trends. While portfolio capital outflows exceeded inflows in the second quarter of 2006, a strong trade surplus led to an overall balance of payments surplus during the same quarter. After pausing in June, BI continued to ease interest rates in the July to October period, moving the Bank Indonesia rate from 12.50% in June 2006 to 10.75% by early October 2006. BI is expected to cut rates further in November and December 2006 if moderate inflation and a positive balance of payments outlook continue, as expected.

¶9. (U) GDP will likely expand at a faster pace in the second half of 2006 due mainly to increased household spending, spurred by the lower interest rate environment, and higher government consumption. A number of trends in recent months point to a rise in household consumption. September 2006 car sales increased over 15% from the previous month, after declining through the first half of the year. Stronger cement sales and an increase in credit growth also point to a recovery in domestic demand. In addition, non-oil imports increased in August in response to more solid demand for foreign raw materials and capital goods. More negatively, BI's consumer confidence index slipped in August, revealing some renewed pessimism among households. Nevertheless, most observers expect to see somewhat stronger household consumption through the end of the year.

Government Spending a Question
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¶10. (U) The GOI expects to increase expenditures dramatically in the second half of 2006. However, as in previous years, few observers expect the Government's end-year fiscal outtake to reach the target deficit of 1.3% of GDP, as bureaucratic obstacles and limited capacity at the local level continue to limit the government's ability to

disperse funds. While slower execution of planned spending will limit the ability of the government to spur growth in the second half of the year, it will keep public debt levels from rapidly rising. In addition, lower world oil prices have reduced the cost of remaining fuel subsidies, contributing to a more stable fiscal outlook.

¶11. (SBU) Most observers expect the current account surplus to shrink but stay positive during the second half of 2006. Stronger domestic demand will support growth, but may negatively impact the trade balance, as import demand rises. In addition, softer world oil prices will reduce the value of crude oil exports in the near term. Nevertheless, observers expect the value of Indonesia's non-oil-and-gas exports to continue to grow as a result of high global prices and strong demand for a variety of Indonesian commodities.

¶12. (SBU) Most analysts expect limited increases in investment during the second half of 2006, limiting the short-term growth outlook. While the increase in capital goods imports points to some increase in infrastructure spending for ongoing projects, there is little evidence of significant new greenfield investment outside of the property sector. The return of macroeconomic stability has piqued some interest from foreign investors, but potential investors still face major obstacles, limiting the amount of realized foreign direct investment. Delays in implementing the GOI's investment climate improvement package coupled with the relatively rapid speed of similar reforms in other countries in the region continue to limit the number and size of investment projects.

Risks to Sustained Growth and Macroeconomic Stability
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¶13. (SBU) In the near term, Indonesia faces few significant risks to macroeconomic stability. While domestic demand will likely accelerate in the second half of 2006, most



observers believe it is unlikely to create significant new inflationary pressures. In addition, BI would likely limit monetary easing if considerable inflationary pressures resurface. World oil prices have been trending downward, limiting the pressure on the budget and Indonesia's balance of payments. Portfolio inflows should remain stable given the significant interest rate differential between the United States and Indonesia and the relative political stability of Indonesia in recent years. While profit taking has resulted in some outflows of "hot money" in recent months, these episodes have not resulted in major macroeconomic disturbances in 2006. Furthermore, Indonesia well diversified export base limits the balance of payments risk from a major correction in commodity prices.

¶14. (SBU) Indonesia's medium-term growth rates will continue to depend on the GOI's success in implementing large-scale reforms to the investment climate and successfully boosting infrastructure spending. Delays in passing new tax, investment, and labor laws continue to undermine investor confidence in Indonesia, and the GOI's infrastructure development program has not yet produced a significant number of projects. Given serious and growing infrastructure bottlenecks and a relatively low investment/GDP ratio, without large new capital investment, Indonesia will have difficulty achieving growth rates above the 6% level projected for 2007.

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